In the Supreme Court of the United States

OCTOBER TERM, 1969

No. 294

SOUTHEASTERN CANTEEN CO. AND CANTEEN SERVICE CO. OF TOLEDO, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinions of the Tax Court (Pet. App. 21–60) and the court of appeals (Pet. App. 1–20) have not been officially reported. They are unofficially reported at P–H Memo T.C., par. 67,183, and 23 A.F.T.R. 2d 69–1362, respectively.

JURISDICTION

The decision of the court of appeals was rendered on May 13, 1969. The petition for a writ of certiorari was filed on June 27, 1969. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. 1254(1).

358-178—69

QUESTION PRESENTED

Whether the disallowance of deductions for the petitioners' excessive and unreasonable "rental payments" and "location commissions" under a sale and lease-back arrangement with a related corporation is supported by the evidence.

STATUTE INVOLVED

Internal Revenue Code of 1954:

> SEC. 162. TRADE OR BUSINESS EXPENSES.
>
> (a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—
>
> * * * * *
>
> (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.
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> * * * * *
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> [26 U.S.C. 162.]

STATEMENT

On June 30, 1960, Virgil A. Gladieux and his wife owned all the outstanding capital stock of fifteen related corporations, among which were the two petitioners in this case (Pet. 8). At this time the Gladieuxs offered to transfer their fifteen corporations to ABC Vending Corporation in exchange for 80,000 shares

of ABC stock, an option to purchase an additional 5,000 shares, and ABC's employment of Mr. Gladieux at $62,500 per annum (Pet. App. 3). Because a third party would not permit the transfer to ABC of petitioners' franchises from it, however, the final agreement called for transfer to ABC of only thirteen of the fifteen corporations, excluding petitioners, in exchange for 68,500 shares of ABC stock, the option and the employment arrangement. This transaction was consummated on January 26, 1961. As of January 31, 1961, one of the thirteen corporations previously owned by the Gladieuxs and now owned by ABC agreed with the petitioner corporations to buy their physical assets at book value and lease these assets back to petitioners at an annual "rental" equal to ten percent of gross sales. In addition, petitioners were to pay increased "fixed location commissions" with respect to sales made at locations derived through ABC's subsidiary, its affiliates, or Virgil Gladieux. Petitioners promptly used the purchase price of the assets to buy 11,500 shares of ABC stock—bringing the total the Gladieuxs owned, either directly or indirectly through their ownership of petitioners, up to the 80,000 shares initially bargained for (Pet. App. 4–5).

Petitioners claimed deductions for "rentals" and "location commissions" in the amount of their payments under the agreement. These claims were disallowed, in part, by the Commissioner. The Tax Court sustained the Commissioner's determination, holding that the sale and lease-back device had been used merely to funnel the petitioners' profits to the cor-

poration now owned by ABC (Pet. App. 42) and that the "rental" payments were in excess of those that would have resulted from an arm's length negotiation (Pet. App. 47). The Tax Court also held that the "location commissions" were not properly deductible, in substance because they lacked any legitimate business purpose and constituted only a further effort to funnel petitioners' income to ABC (Pet. App. 51). The court of appeals affirmed (Pet. App. 1–20).[1]

ARGUMENT

The only issue in this case is the reasonableness of certain claimed business expense deductions. The issue is purely factual, and the decision below is correct in holding the payments involved to be unreasonable. There is neither conflict among the circuits nor any other reason for review in this Court.

Section 162(a)(3) allows as a deduction "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including * * * rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity." A deduction claimed under that section is allowable, however, only if the amount paid is actually for rent,

[1] The court of appeals reversed the Tax Court's disallowance of surtax exemptions petitioners claimed (Pet. App. 13-20). The government has not sought review of this issue, decided favorably to petitioners, since it involves only evidence questions.

rather than for something else in the guise of rent. *Place* v. *Commissioner*, 17 T.C. 199, 203, affirmed, 199 F. 2d 373 (C.A. 6), certiorari denied, 344 U.S. 927. Although there is no express requirement that amounts claimed as rental deductions be reasonable in amount, it is well settled that where a close relationship exists between lessor and lessee, there must be a determination whether or not the lease was negotiated at arm's length. *Stanwick's, Inc.* v. *Commissioner*, 15 T.C. 556, affirmed, 190 F. 2d 84 (C.A. 4); *Midland Ford Tractor Co.* v. *Commissioner*, decided December 17, 1958, 17 T.C.M. 1660, affirmed, 277 F. 2d 111 (C.A. 8), certiorari denied, 364 U.S. 881; *Potter Electric Signal & Mfg. Co.* v. *Commissioner*, decided February 26, 1960, 19 T.C.M. 160, affirmed, 286 F. 2d 200 (C.A. 8). If it is determined, as here, that the lease was not so negotiated, there is a further inquiry as to whether the amount paid for rent was in excess of the amount that the lessee would have been required to pay had he dealt with a stranger. *Place* v. *Commissioner, supra.*

Viewing the evidence as a whole, the courts below reasonably concluded that the rentals petitioners paid under the sale and lease-back agreement were unreasonable and bore no relationship to the fair rental value of the leased equipment (Pet. App. 5–9, 39–49), and that petitioners' payment of the excessive rentals and location commissions reflected their owners' attempt, by funneling their profits to ABC, to approximate their original arrangement with ABC (Pet. App. 7–8, 41–43, 53–55). In asserting that these conclusions were factually incorrect (Pet. 27–28), petition-

ers ignore the mandate of the "clearly erroneous" rule enunciated in *Commissioner* v. *Duberstein*, 363 U.S. 278.

These conclusions are not impeached by the court's failure to supply a detailed definition of "arm's length bargaining" (Pet. 28). Courts have consistently—and properly—refused to do so in view of the unlimited number of situations in which the question may arise. See, for example, the Treasury Regulations promulgated under Section 482 of the 1954 Code, which supply some guidelines for determining an "arm's length" allocation of income and deductions between commonly owned or controlled entities. Treasury Regulations on Income Tax (1954 Code), Sec. 1.482(c)(2) (26 C.F.R. 1.482–2(c)(2)). Any necessary protection is provided by the additional requirement of inquiry to determine the reasonableness of rents paid where arm's length bargaining is absent. And the rents involved in this case plainly were unreasonable.

Nor is the treatment below condemnable as "double taxation" (Pet. 25–26). While it may be true that petitioners may not now offset their gross incomes by taking a deduction for the excessive "rents" and "location commissions," it does not follow that the denial of a deduction for a claimed expense item is "double taxation." Excessive rentals are not ordinary and necessary business expenses, and therefore are not deductible as such. *Potter Electric Signal & Mfg. Co.* v. *Commissioner, supra; Midland Ford Tractor Co.* v. *Commissioner, supra.* The fact that there is contractual liability

for the excessive rent makes no difference. *Interstate Transit Lines* v. *Commissioner,* 319 U.S. 590, 593.

Petitioners' reliance on *Commissioner* v. *Tellier,* 383 U. S. 687 (Pet. 25), is misplaced. In *Tellier* the question was whether expenses incurred in defense of a prosecution for violations of the securities laws were ordinary and necessary expenses "appropriate and helpful" to taxpayer's business as a securities dealer. In concluding that they were, this Court characterized the federal income tax as a tax upon net income as opposed to a sanction against wrongdoing. But those payments were unquestionably an expense. No such issue is presented here, where the "rental" payments are in reality a device to funnel petitioners' income to a corporation in lieu of a sale to that corporation.

Finally, the decision below does not conflict with *Skemp* v. *Commissioner,* 168 F. 2d 598 (C.A. 7), and *Brown* v. *Commissioner,* 180 F. 2d 926 (C.A. 3). Both the *Skemp* and *Brown* cases turned on a determination that the rents involved were reasonable. Secondly, the rents in those cases were exacted by a lessor who was in no way connected with the lessee. In this case the lessor and lessee were closely related by ownership during the negotiations for the sale and lease-back and, indeed, remained related by ownership, albeit less directly, after the sale and lease-back arrangement was consummated.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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